Corporate Governance-Some Issues

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From early days, the economic well being of individuals is one of the main goals of human existence. This is articulated in the Hindu concept of the four Purusharthas, which start with Dharma and Artha.

While the pursuit of economic wealth is recognised as a legitimate objective, it is predicated upon the first objective namely Dharma. Earning and accumulation of wealth has therefore to be based on right conduct.

In modern economic terms, the concept of individual effort, earnings and accumulation of wealth was put forth by Adam Smith in the 18th Century as complex social formations based on division of labour, and the separation of capitalist and non-capitalist groups came to be recognised as an essential part of society.

As individuals began to feel the necessity of complementing each others skills to maximize the benefits of common action, the original idea of owner-proprietor and owner-worker began to be more complex. Ownership and workers began to get separated and, capital and labour assumed individual significance of their own.

In the early years, owner-proprietors were the order of the day. When partnership began to emerge as a way of pooling financial resources, for acquiring capital goods, for improving productivity and efficiency. Towards the end of the 19th Century forming of stock companies with wider ownership became the order of the day. Complex laws were enacted not only to enable large numbers of investors to participate in capital formation and to maximize efficiency and productivity. The separation of ownership and management also came to be recognised as an essential part of corporate evolution. With increase in the number of investors in joint stock companies, there began to emerge the small investors who wanted to participate in capital formation but did not have the time or means to participate in the management of the company.

After the end of the Second World War the competition between the Communist and Capitalist economies competed with each other and soon it became clear that the capitalist system gave better returns to the people in terms of living standards, more goods with better choices for the consumers. However in terms of health care and education for all, the Communist system gave better results. Peoples' freedom was curtailed in the communist countries.

On the whole the capitalist system was considered superior. After the collapse of the Communist regimes and their replacement by a hybrid system socialist capitalism then former communist countries were actively and effectively competing with the capitalist world. They had a higher growth rate and their trade surpluses helped them to build huge foreign exchange reserves. The events of 1980 showed the ill effects of having an unbridled capitalist system which tempted a number of people, high and low to make a quick buck by joining the gambling game.

One of the main planks of the capitalist system till recently, was a sense of rectitude in the market, particularly among the bankers, and a level of regulation which acted as check against excessively greed. When this began to lose its intent and purpose the rot began to set in. Investment banks, commercial banks, companies began to tumble one after the other. The housing scam followed by cheating in other companies, by falsifying the accounts with the connivance of the top management led to a collapse of the system with some people making huge amounts at the expense of a large number of gullible and greedy individuals.

However, the savings of the small investors were placed in the hands of the management of Banks, who could leverage on their own resources with the large resources of a number of small investors. The need to protect the interest of small investors emerged as one of the objective of State intervention and to protect the small investors from fraud and mismanagement.

Over two decades ago the Bank for International Settlements (BIS) laid down norms for ensuring solvency of banks by laying down the capital risk weighted asset ratio (CRAR) at 8 per cent in all banks of member countries. This was called the Fist Basal Accord. Currently in India, the banks have been asked to stay within the norm of 10%. However in the case of western banks there has been very lax regulation with the result that banks undertook huge risks without raising the level of their own capital. Moreover banks resorted to innovative and off-balance sheet financing. The Central banks of western countries have been over looking this aspect of regulation for the last several years, with mild reminders of "irrational exuberance". The securities regulation bodies also did not enforce their own rules for trading in stock exchanges. Mortgage financing was allowed to grow uncontrolled. All these acts of omission and commission have made their contributions to the financial crisis. The recent statement of the G20 leaders recognises that major failures in financial sectors and in the financial regulation and supervision were the fundamental causes of the crisis. The statement assures that they will take action to build a stronger, regulatory framework. It also recognises that regulators and supervisors must protect consumers and investors.

The good features of capitalism have been overtaken by rampant risk taking and endangering the financial viability of institutions and individuals. The free market of capitalism has been substituted by a free for all market of irresponsible capitalism. Another area in which regulators were at best silent spectators and at worst collaborators, is in the excessive remuneration and bonuses given to chief executives of failing institutions at the expense of the tax payer. In the early days this used to be called as a regime of robber barons.

A combination of all these factors has placed a heavy burden on several governments who have been compelled to raise taxes to support failing institutions and organisations.

It is only in the last 20 years that Corporate Governance as a concept of protecting the interest of the small investors and to prevent their oppression at the hands of the management came to attract attention. The large size of companies with huge amounts of savings of millions of small investors compelled the State to intervene by enacting various laws. However, historically it is seen that the attribute of every new law is a number of loop holes provided for wrong doing.

The Western industrialized nations witnessed the proliferation of multi nations corporations with accumulation of capital around the world, with manufacturing facilities distributed in many countries and ownership of shares distributed among investors around the globe and market place for the sale of individual shares spreading through numerous stock exchanges in several countries. New financial instruments proliferated by the introduction of derivatives, interest swaps, exchange rate etc. The field for risk taking was widened and with it grew opportunities for fraud of colossal proportions.

In this complicated setup many opportunities arouse for defrauding gullible small investors. Complex financial systems provided opportunities for financial fraud where individuals enriched themselves at the interest of numerous small investors by falsifying accounts, and presenting a wrong picture of the financial wealth of the company to justify their existence and to attract more funds.

Corporate Governance is a recent term for an age old concept. It essentially means that those in charge of the management of companies conduct the affairs of the company in an ethical manner in the interest of all the stake holders.

If we had to trace the major significant events leading to reform in Corporate Governance over the last 20 years, one can begin with the case of Robert Maxwell, a media magnate who committed suicide in 1991 when the financial mismanagement and malfeasance of his media group came to light. The Government of the UK set up a committee under the Chairmanship of Adrian Cadbury, Chairman of the Cadbury (chocolate) group of companies to look into the financial aspects of Corporate Governance. The Cadbury Committee report which came out in 1992 laid down guidelines for ethical rules of financial management, independent directors, audit committees etc. It required a company management to disclose the correct financial picture of the company. This was followed by other committees like the Greenbury Committee (1995) dealing with directors remuneration, financial rewards for the management afforded by the Confederation of British Industry. Greenbury was Chairman of the retailer, Marks and Spencer.

In the US, similar action was taken by the US Congress passing the Sarbanes Oxley Act of 1996, which also laid down strict norms for financial transparency in the management of companies.

Inspite of all these measures for better regulation in the last 10 years, the number of cases of mismanagement, fraud and the selfish greed of the management have all been highlighted in a number of cases of companies, banks and other financial institutions, emptying the coffers of the companies by dishonest management causing loss to the numerous investors.

The main reason of this state of affairs could be attributed to lack of and adequate enforcement of the laws. The collusion between political parties and regulatory bodies enable the wholesale cheating of small investors. Starting with the decades old method adopted in the Ponzi schemes by which deposits are accepted from gullible investors while promising very large returns. The earlier investors were given high returns by utilizing the deposits of subsequent investors. The methodology followed by Ponzi_in the USA was followed a few decades later by Gopal Rao in Bangalore in 1946 and by Sanchaita in Calcutta in early 70s and the most recent example of the use of Ponzi methodology is seen in the fraud of Madoff in the USA, where billions of dollars of investors money was lost by those who fell for the stories of huge returns of 35-40% per year. Gopal Rao gave a return of 48% per year or 4% per month to investors out of fresh deposits for 2 years before he collapsed. In India, there are numerous instances of non-bank financial companies (NBFC) taking deposits from gullible small investors. The regulation of NBFCs was in no man's land between the SEBI and the Reserve Bank till 1995, when the_regulation of NBFCs came under the jurisdiction of RBI.

The implementation of the Western equivalent of Corporate Governance regulation was formalized in Clause 49 of the Listing Agreement of Stock Exchange as laid down by SEBI. These covered the main areas of independent directors, auditors and audit committees. After the Satyam scandal, the several defects in the implementation of the scheme have now been highlighted and remedial action is being debated. It is reported that only 57% of the listed companies have complied with this clause. The main areas calling for change are dealt with below:

Independent Directors: Companies are required to have atleast three independent directors with qualification and experience in corporate affairs, finance and economics etc. were supposed to ensure that the operations of the company were transparent and interest of small investors is protected. By the very nature of the selection and appointment, independent directors could not be independent of the management. When such directors are selected by the managements, remunerated by the managements and given various perks and amenities by the management, they could not be expected to be really independent and impartial in overseeing the functioning of the company. An obvious solution should be on the following lines:

1. Management should not select the independent directors. A panel of about 500 independent directors should be prepared and kept by SEBI. Only those persons who have the ability, experience and the willingness to act as watchdogs to protect the interest small investors should be placed in the panel. From this panel, SEBI can nominate 3 independent directors or 50% of the Board on the Board of Directors of Companies having more than 2 or 3 Lakhs share holders. No person can be an independent director in more than 3 to 5 companies.
2. The independent directors of a company could be from the field of law, financial and relative fields.
3. The remuneration of the directors also should not be fixed by the management. Depending on the size of the company and on the market capitalization, three different slabs of monthly remuneration can be fixed with the largest companies paying Rs.5 Lakhs per director per year and lower amount for smaller companies. For the payment of the remuneration, a separate fund can be created by SEBI from contributions from the companies themselves. The names of independent directors and their remuneration will continue to be publicized in the annual accounts of the companies. Investors having complaints about the financial management can write to these directors. Greater resort should be had to the provisions of the Company Act and the Company Law Board (CLB).

Audit Committee: The Audit Committee of the company formed from the independent directors will as at present meet without the presence of the CEO and may call the CFO for providing clarifications. The statutory auditors may also be called in to clarify matters by the audit committee. The management at present, selects the auditors, fixes remuneration and continues their appointment for an indefinite period. This system also requires review with the external auditors term be limited to 3 years and the rotation of auditors may be supervised by the SEBI or CLB.

It has also been observed that auditors who have been found wanting in their diligence or honesty are not dealt with adequately. The Institute of Chartered Accountants should have a large role in examining the role of auditors. If after a suitable enquiry, auditors are found lacking in the honesty and integrity should be debarred from acting as auditors to any other company for a period ranging from 5 to 15 years. In the US, large fines are levied on errant auditors without a prolonged enquiry. This practice should also be followed in India.